APS ORIGINAL

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Commissioner Kristin K. Mayes
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007-2996

RE: APS' Cost-Containment Measures E-01345A-06-0009

Dear Commissioner Mayes:

This letter is in response to your January 11, 2006 letter regarding the cost management efforts at Arizona Public Service Company ("APS"). Before turning to those issues, however, I want to stress that the financial crisis facing the company and its customers is primarily the result of the mounting fuel and purchased power costs that APS has been unable to recover on a timely basis under the Commission approved PSA, and not because of some shortcoming in APS' cost management processes. Our difficulties are further compounded by a "price squeeze" (similar to that recently faced by California and other utilities) that has customers paying rates based on 2002-2003 expenses while APS must pay the much higher 2006 costs to provide service.

That being said, your letter asks about APS' commitment to contain its costs and expenses. To be clear, managing costs is an integral part of APS' philosophy. In light of record customer and energy growth, our challenge has and will continue to be managing costs that do not compromise our ability to reliably serve our customers at reasonable costs both today and in the future.

With that introduction, let me address your inquiries.

APS Hedging Policies and the Annual Fuel and Purchased Power Cap

In your letter, you refer to: "our apparent failure to keep APS' natural gas purchases under the $776.2 million cap on annual power supply costs." This statement reflects a fundamental misunderstanding of the goals of a responsible hedging policy and would implicitly suggest some imprudent fuel and purchased power steps by APS.

A hedge is a technique designed to reduce or eliminate price risk—it is not designed to lock in a predetermined future cost figure irrespective of (i) high premium costs, (ii) the loss of market flexibility, or (iii) the increase in volumetric risk associated with higher levels of hedging. Since the prices of natural gas and purchased power are extremely volatile, and energy requirements fluctuate on both short term and long term periods, a sound hedging philosophy allows APS to eliminate much (but not all) of the price risk for customers associated with the often dramatic short and mid-term price fluctuations in these markets without incurring the counter-vailing diseconomies described above.

APS has hedged natural gas and purchased power requirements for native load customers for a number of years, with price stability properly being the primary underlying goal of our system hedge philosophy. Through our system hedge approach, financial risks associated with projected fuel and purchased power requirements are systematically hedged at various levels during the three years prior to delivery. Our hedging practices involve setting definitive target hedge levels, strict compliance in meeting those hedge levels, and utilizing sophisticated buy/sell strategies, all undertaken with senior management oversight and direction. APS' system hedging philosophy does not try to guess the direction of the commodity markets—that is what speculators do, and we do not believe it is appropriate to speculate on behalf of our customers.

By hedging 85% of our purchased power and natural gas needs using pre-established intervals and hedge percentage levels over a three-year horizon, APS can mitigate the impact of volatile natural gas and purchase power prices and still allow for changes in load and other short term market variables. Some of the specifics of our hedging policy and practices were outlined in detail during the Commission's September 2005 natural gas workshop. Because price stability, and not speculative gain, is the goal of hedging, the economic impact of hedging can and will vary with the swings in commodity prices in short term markets. For example, if a hedge is purchased and valued at a cost below the current market value, the value of the hedge itself is positive, and can result in lower costs to the customer versus relying on spot market prices for procurement. This was the case for APS in 2005, when the value of hedging saved APS ratepayers approximately $120 million in fuel and purchased power costs. Put another way, if APS had not hedged and instead relied solely on the short term markets to purchase its projected gas and purchased power volumes, the eventual costs of those commodities would have been $120 million higher. Similarly, while the market value of hedges changes daily with the corresponding changes in market prices the value of APS' forward year hedges measured as of January 10, 2006 for the years 2006 and 2007 are as follows:

— Calendar 2006: $128 million

— Calendar 2007: $110 million

It is important to note that, notwithstanding the above financially positive positions stemming from our hedging program, the value of these hedges could be reduced or eliminated if the short term price of gas and purchased power were to drop lower than the hedged price. In those instances, even though the primary goal of price stability is realized, the final costs of hedging would be higher than if we had relied (but only with the benefit of hindsight) exclusively on short term market prices. Such a result would not mean that the hedges were imprudent. Described another way, hedging is essentially price insurance. Insurance does not lose its value nor is its purchase imprudent simply because the risk insured against does not materialize.

A sound hedging philosophy is a critical element to our business. The failure to follow an established hedge plan, and instead wait for the spot market can be catastrophic, as commodities market trading has proven time and time again. Just as risky is a hedging program that tries to predict the market or one that fixates on a specific cost figure. Our hedging program is a sound risk management tool and provides a long-term safety net for APS customers.

<u>Other fuel-related cost containment efforts</u>

Aside from hedging, APS has taken other steps to contain fuel and purchased power costs. The following are just a few examples of such steps:

- ✓ Power Plant Efficiency/Unit Uprates Projects — Annualized fuel savings from increasing the efficiency/uprating the capacity at several APS units (Palo Verde, Cholla, and Redhawk) will save ratepayers an estimated $38 million in 2006 based on December 31, 2005 forward market prices.

- ✓ Nuclear Fuel Procurement — By consolidating purchases APS has achieved approximately $23 million in savings over the last two years.

- ✓ Coal and Coal Transportation Agreements — Through active management of its coal and coal transportation agreements, APS' average coal expense increases have been limited to 23% since 2000, in comparison to the Powder River Basin market, where prices have increased by over 100% during the same period. Part of these savings resulted from multi-year negotiations to improve rail economics and service with Burlington Northern Santa Fe in support of our Cholla generating station and contractually fixing the term of the contract for lower cost incremental pricing for our Four Corners generating station. Moreover, APS anticipates its recently executed 19 year, 65 million ton coal supply agreement with Peabody Energy will lend itself to improved economics for the Cholla generating station relative to future coal purchases in light of today's current market conditions.

- ✓ Natural Gas Transportation Agreements — Active management of the El Paso Natural Gas Transportation agreements have produced annual savings of more than $4 million per year.

<u>Capital Infusions and Dividends</u>

A review of APS' revenue deficiency for the years 2001 through 2005 shows that APS failed to earn its allowed return on equity by over $220 million. This equates to a pre-tax revenue shortfall from customers (and a loss to shareholders) for the same period of over $370 million. In addition, the company's shareholders have absorbed almost $19 million of presumptively prudent 2005 fuel expenses through the 90/10 sharing feature of the PSA. As fuel and purchase power costs increase, so too will this loss to shareholders. By the end of 2006, we estimate the portion of otherwise recoverable fuel costs borne by shareholders will have grown to more than $45 million.

Your letter suggests additional equity infusions from Pinnacle West to APS. In the last twelve months, Pinnacle West has infused $460 million of equity into APS. Without this infusion of equity by Pinnacle West, APS would already be "junk" rated. It also makes APS' capitalization structure 54.5% equity.

The problem with our financial health is weak funds (i.e. revenues) from operations in comparison to our projected construction expenditures and our total debt, and not from any the lack of additional equity investment. Because of the significant mis-match between the price of fuel charged customer, and the costs incurred by APS, cash flow from customers is simply not sufficient to cover purchased power and fuel costs, operating expenses and construction expenditures. APS can survive short periods of time with weak cash flow, but eventually its financial health is compromised if such cash flow condition persists. This is why we find ourselves on the edge of a "junk" bond rating. As a result of such a rating, as detailed in our filed testimony, estimates are that the amount of additional annual interest expense would grow to $115 million to $230 million by 2015; a cost that can easily be avoided by aligning fuel and purchased power costs paid by the customer with those paid by APS.

On the issue of dividends, APS' dividend has remained unchanged since 1991. Cutting APS dividends would further and dramatically affect the equity market's negative perception of APS and Pinnacle West. In fact, I doubt that Pinnacle West would have been able to raise the $250 million of new equity in April of last year which was infused into APS, had it or APS been cutting dividends. Because APS is the second fastest growing electric utility in the nation, it is vital that we remain an attractive investment in all financial markets. It is difficult to imagine that any prudent investor would invest their money into a company with significant and growing unrecovered costs, sub par returns and the cutting of dividends. Finally, for the same reasons discussed with reference to additional equity infusions from Pinnacle West, a reduction in the APS dividend would not resolve an operating cash deficiency caused by the Commission's failure to permit timely fuel cost recovery or provide the financial community any greater assurance as to the recovery of fuel and purchased power costs, which is the source of its concerns.

Non-fuel cost management

In your letter, you reference executive bonuses, travel and advertising. Together, these account for only 0.2% of our costs. Moreover, they represent an even smaller amount of the revenue increase we are asking for in our permanent rate case. Nevertheless, I will attempt to address these items as well as the other non-fuel cost containment efforts being made by APS.

Let me first discuss advertising and APS' involvement in local sporting events. APS has been and continues to be an active participant in supporting our state and the communities we serve – but we are not asking that the funds that underlie this involvement come from customers. The communications costs included in our permanent rate filing are related to conservation/energy efficiency and customer service messages. APS customers do *not* absorb charity costs or the other cash and non-cash contributions we make for the benefit of Arizona communities. Moreover, the volunteer hours by our employees across the many worthwhile projects have been among the highest of any Arizona based company but likewise do not cost APS customers anything, yet clearly bring value to the community.

The issues of executive incentives and travel are not germane to the recent emergency filing, which is focused solely on the fact that APS has still not been reimbursed hundreds of millions of dollars in purchased fuel and power costs to meet its ratepayers' power requirements. For your information, the test year required by Commission Staff for our pending permanent rate case contains officer salaries at 2004 levels and no executive incentive payments and minimal travel expenditures. While the review and determination of the recovery of those costs, however de minimis, is appropriate in the pending rate case, we believe it is not material in evaluating the current emergency filing.

Let me now turn to the more generic question of cost management in the non-fuel area. APS has a long record of actively pursuing disciplined cost management as a tenet of our business. APS has successfully managed costs and staffing levels over the last several years, while meeting customer growth averaging around 4% per year. Between 2001 and 2005, operating costs as a ratio of energy sales (measured in cents / kwh) have remained in the 2.0 to 2.2 cents/kwh range. During that same time, the customer per employee ratio has grown from 196 customers per employee in 2001 to 220 customers per employee in 2005, an improvement of 12%. Our construction cost of each residential meter set from 2001 through 2005 has increased less than 3% per year, well below the inflation rate of raw materials and labor for this task. These bottom line results are even more impressive considering that APS serves a larger and more sparsely populated territory than other utilities in Arizona.

Virtually every APS department has worked to reduce or contain its costs and expenses. The following are samples of steps which have and will result in savings to APS ratepayers.

- ✓ Taxable Debt Interest Savings — APS' treasury department implemented an aggressive strategy of renegotiating debt service requirements which result in an annual interest savings of more than $22 million compared to 2000.

- ✓ Tax Exempt Portfolio Savings — During the period of 2001 through 2005, the APS treasury department realigned APS' tax exempt debt in order to achieve interest savings and to diversify credit support. As a result of this realignment, annual savings are more than $3 million.

✓ APS has implemented over the last several years aps.com to handle certain customer inquiries and transactions resulting in estimated savings of approximately $3 million annually.

The above are but a small sample of actions we take every day to undertake every reasonable measure to look out for our customers. In the last decade, while power prices have rocketed skyward and rolling brownouts caused by lack of generation capacity have been occurring in other states, we have stayed steadfast in our commitment to providing Arizona customers reliable energy and the reason we were able to reduce our prices 16% prior to April of last year was because of these efforts. We are proud of our record of reliability and proud of our efforts to contain costs for APS customers.

Conclusion

Our financial health is vitally important to customers, shareholders, employees and to all Arizonans, whose economic prospects are surely dependent on a strong APS capable of supporting the continuing growth of our state.

The company's base rate case will provide sufficient opportunities for all parties to review the company's overall costs in depth. The interim filing (which is subject to refund based on the final rate case decision) is about unrecovered fuel costs which have placed the company in a precarious financial position that needs to be remedied immediately.

Very truly yours,

Jack E. Davis
President & CEO
Arizona Public Service Company

cc: Chairman Jeff Hatch-Miller
Commissioner William A. Mundell
Commissioner Marc Spitzer
Commissioner Mike Gleason
Ernest Johnson
Brian McNeil
Heather Murphy
Docket